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SUBJECT: 2006 NATIONAL TRADE ESTIMATE FOR KAZAKHSTAN

REF: STATE 186692

1. Per Reftel request, Embassy Almaty submits 2006 National Trade Estimate (NTE) below and separately via email to USTR.

TRADE SUMMARY

(UPDATED DATA TO BE PROVIDED BY USTR)

Kazakhstan submitted its application for WTO membership on January 29, 1996 and the fact-finding phase of the accession process was completed in 2003. Kazakhstan's Working Party met in March and November of 2004, and it recognized Kazakhstan's progress by circulating a draft Working Party Report in 2005. Kazakhstan has undoubtedly made progress, but the details of market access in several sectors still need to be negotiated. For example, it successfully reached bilateral agreements with several of its large trading partners in 2005, including China, Pakistan, Turkey and the Republic of Korea.

The U.S.-Kazakhstan Bilateral Trade Agreement, which came into force in 1993, grants reciprocal, normal trade relations treatment. A bilateral investment treaty (BIT) came into force in January 1994.

IMPORT POLICIES

Kazakhstan is a member of the Eurasian Economic Community (EAEC) along with Russia, Kyrgyzstan, Belarus and Tajikistan. Moldova and Ukraine currently have observer status. Trade among the five EAEC countries is generally duty-free, but protective measures may be applied. The countries have not yet established a common external tariff. The EAEC is developing coordinated customs procedures, which it hopes to complete in 2006, that would reduce the cost of transshipment through the EAEC member states of U.S. goods destined for Kazakhstan. Kazakhstan is also (with Russia, Ukraine and Belarus) part of the Single Economic Space (SES), a nascent customs union. Kazakhstan is committed to deeper integration with its neighbors through SES, but the progress of this organization has been hampered by uneven levels of enthusiasm from its members, as well as by the sheer number of founding documents that must be negotiated.

The average weighted import tariff in Kazakhstan is approximately 7.9 percent, and its value-added tax (VAT) rate has been 15 percent since January 2004. Imported goods are subject to VAT on the dutied value of the goods, at the time of importation (VAT destination principle.) In early 2005, Kazakhstan eliminated the one exception to this rule, which had applied VAT before export to oil and oil products imported from Russia.

Goods imported for short-term use in Kazakhstan under a temporary import regime can be fully or partially exempt from duties, taxes and non-tariff regulations. The government has the right to issue a list of goods that cannot be temporarily imported into Kazakhstan. Typical examples of goods not eligible for duty exemptions are food products, industrial wastes and consumables.

As with the 1994 Foreign Investment Law, the Law on Investments, enacted in January 2003, provides customs duty exemptions for imported equipment and spare parts, but only if Kazakhstan-produced stocks are unavailable or not up to international standards.

CUSTOMS PROCEDURES

Kazakhstan's new Customs Code became effective May 1, 2003, superseding the law of 1995. There are positive changes in the Code, such as provision for WTO-compliant customs valuation methodologies; however in practice customs administration remains a problematic aspect of trade. In addition, key provisions for such practices as voluntary disclosure are not included in the Code.

The customs authorities continue to discuss the automation of customs procedures, but little progress has been made.

Since October 2002, Kazakhstan has maintained a "customs audit" procedure administered by a private contractor. The private contractor determines customs value based on a database of world prices, in contravention of international standards. Under this system, approximately 20 percent of all goods crossing Kazakhstan's borders are subject to valuation uplifts. While the government pays for inspections, the declaring party pays penalties in the event of discrepancies. There are concerns that this process is used to generate extra-legal revenues beyond existing duties and taxes. Courts have decided over 85 percent of all appeals under this system against the Customs authorities. In addition, Ministry of State Revenues Order 402 sets

conditional prices for certain imports, a practice inconsistent with international norms.

U.S. companies have consistently identified Kazakhstan's requirement that they obtain a "transaction passport" to clear imported goods through customs as a significant barrier to trade. This regulation is designed to stem capital outflows and money laundering by requiring importers to show copies of contracts and other documentation to legitimize and verify the pricing of import/export transactions. The practice retards the growth of trade, as the regulations place relatively tight restrictions on transaction parameters. For example, the regulations allow a maximum financing term for imports of 120 days, after which time the transaction passport must be closed out. This limits the range of business activity and creates a potential bias towards short-term financing in the economy.

STANDARDS, TESTING, LABELING AND CERTIFICATION

Kazakhstan's system of Metrology, Accreditation, Standards and Quality (MAS-Q) in Kazakhstan has long been considered by businesses to be weak and fragmented. Many businesses complained of mandatory certification requirements that have no technical basis or aim. The Committee on Standards, Metrology and Certification - Gosstandart (the national governing body operating under the Ministry of Industry and Trade) was plagued by frequent management changes that make stable, long-term progress difficult. Government observance of existing standards, testing, labeling and certification requirements was reported to be uneven.

In response to these well-known deficiencies, Kazakhstan adopted new legislation in 2005. The legislative base governing technical regulation and metrology in Kazakhstan now consists of the laws "On Technical Regulation", "On Ensuring Uniformity of Measurement" and on supporting government regulations, which were adopted in furtherance of the Government's 2004-2006 national program for the development of national systems of standardization and certification. Of the Government's regulations, the most fundamental is the entitled "On the mandatory confirmation of compliance of products in the Republic of Kazakhstan".

The law "On Technical Regulation" was signed on November 9, 2004, and came in effect on May 13 2005. This new law supersedes two previous laws, "On Standardization" and "On Certification." The main purpose of this law is to set the division of responsibilities between the state and private sector: the government is responsible for product safety, while the private sector is responsible for quality control.

Though this new law cancels the laws "On Standardization" and "On Certification", some approaches from the old laws have been maintained. According to the new law, a wide range of goods are subject to mandatory certification requirements. The certification requirements apply to both domestically produced and imported goods. A related regulation lists the categories of products subject to certification, which include but are not limited to machines, cars, agricultural equipment, clothes, toys, food, and drugs.

Standards for imported goods are addressed further in the law "On technical regulation." That law specifies that contracts for the delivery of imported goods subject to mandatory certification should have a liability to confirm compliance. Such contracts should be accompanied by documents describing the products and listing the country of origin, the producer, the expiration date, storage requirements and code of use in both the Kazakh and Russian languages. In addition, the law states that foreign certificates, testing protocols and compliance indicators will be in accordance with international treaties.

The government has accepted placement of Kazakh language stickers on products as compliance with the law, instead of requiring entirely new labels. The government has also issued a wide-ranging regulation exempting pharmaceutical products and several other categories of goods from the Kazakh labeling requirement.

GOVERNMENT PROCUREMENT

Kazakhstan is not yet a member of the WTO Agreement on Government Procurement. However, with the support of the World Bank, it is reforming and harmonizing its system of state procurement. Nonetheless, some potential U.S. investors have raised concerns about the transparency and efficiency of Kazakhstan's government tender process.

The State Procurement Agency was established by Presidential decree in December 1998, and the Regulation on the State Procurement Agency was approved in March 1999. In October 2004, the State Procurement Agency was merged with the Committee on Financial Control, and was accordingly subordinated to the Ministry of Finance. The procurement process in Kazakhstan is regulated by the law "On State Procurement," and by the Budget Code, the current incarnation of which took effect in 2004 and applies to the republican budgets for 2005 onward.

The Government has taken steps to improve the transparency of the procurement process. In particular, the Committee published on its website the State register of agencies and state enterprises subject to state procurement regulations, the Rules of Inclusion and Exclusion that determine whether an agency or a state enterprise is subject to government procurement regulations and a blacklist of unfair and unreliable suppliers of goods and services.

However, the situation still leaves much to be desired. Since January 2005, about 240 claims against Ministries and state enterprises have been lodged in court. An inspection by the Finance Ministry identified procurement violations in the amount of 81 billion tenge (about \$ 602.2 million) during the first nine months of 2005. The need for legislative improvement in this area is basically undisputed.

The Rules on Oil and Gas Procurement, which went into effect in 2003, also give significant preferences to local suppliers, and establish what many firms, foreign and domestic, consider unwarranted state interference in even small tenders. Despite governmental promises to amend the Rules, they stand as originally written. There have been no reports yet of attempts to enforce the Rules.

In October 2002, Kazakhstan adopted "Rules for the Organization and Holding of State Procurement." These rules established a standardized format for publicizing tenders and specified in which newspapers the offers should appear, based on the newspaper's circulation and the tender's value.

U.S.-funded assistance projects are helping Kazakhstan to establish a database to assist in procurement. The database was launched by the State Procurement Agency in 2003, but remains a work in progress.

INTELLECTUAL PROPERTY RIGHTS PROTECTION

The 1992 U.S.-Kazakhstan Agreement on Trade Relations incorporates provisions on the protection of intellectual property rights (IPR). As part of its effort to join the WTO, Kazakhstan began in 2003 to bring its IPR legislation into compliance with the WTO's Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS Agreement) and other international conventions and agreements.

Nonetheless, the United States Government has consistently identified intellectual property rights (IPR) protections in Kazakhstan as needing improvement. In 2004 Kazakhstan was identified on USTR's "Special 301" Watch List and an industry-initiated GSP case remains open. However, in 2005 as in 2004, the Government of Kazakhstan made steady, if slow progress toward bringing the country's IPR regime into compliance with its bilateral and multilateral obligations.

In 2004 Kazakhstan ratified the World Intellectual Property Organization (WIPO) Treaties on Copyrights and the Uses of Performances and Phonograms. The Law on Copyrights was also amended to guarantee retroactive protection to copyrighted works. In addition to legislative initiatives, Kazakhstan has worked cooperatively with law enforcement agencies, public organizations and international organizations to fight piracy.

Criminal penalties for IPR violations were adopted in 2001, but the law did not provide deterrent fines and set an unreasonable burden for the prosecution to prove the seriousness of the damage suffered by the right-holder. New criminal penalties adopted in late 2005 address these deficiencies. Under the new law, penalties are tougher, the threshold for an offense to be treated as criminal rather than administrative is lower, and the harm standard is replaced by a standard that measures the monetary value of

the violation. As the law is new, it remains to be seen what effect the new penalties will have on enforcement nationwide. The new law is, however, a definite improvement.

In 1999, Kazakhstan also amended its Customs Code to provide for the seizure at the border of items that violate IPR. However, there is little border protection for the importing of illegal material, and illegal sound recordings continue

to be imported, particularly from Russia and China.

In October 2003, the Kazakhstani Ministry of Justice held a national campaign for IPR in accordance with the Justice Minister's decree of September 30, 2003, aimed at studying the cause for the high incidence of piracy and developing an appropriate strategy for protecting IPR in Kazakhstan. The campaign was held to raise public awareness on property rights issues; generate dissatisfaction among the public with piracy and other illegal activities violating IPR; develop methods of strengthening the working relationships between various state authorities concerned with IPR and improving law enforcement practices; and soliciting suggestions for improving IPR legislation. The campaign continued in 2004, when the IPR Committee of the Justice Ministry, among other actions, began publishing a quarterly journal on IPR issues.

SERVICES BARRIERS

Oil and Gas Procurement Regulations, enacted in June 2002 (see Investment Barriers, below) stipulate that oil companies purchase services only from Kazakhstan-based companies unless the required service is unavailable in Kazakhstan.

INVESTMENT BARRIERS

Kazakhstan's new Investment Law, passed in January 2003, supersedes and consolidates past legislation, but according to major investors and law firms, represents no marked improvement. There is concern about the Law's narrow definition of investment disputes, lack of clear provisions for access to international arbitration, and little stability protection for contracts signed after the law went into effect. On the plus side, the Law eliminates time limits for stability clauses for existing contracts, and in some cases, notably Oil and Gas, gives precedence to sector-specific legislation.

For several years, there has been a growing trend to favor domestic over foreign investors in most state contracts. The 1999 amendments to the Oil and Gas Law required mining and oil companies to favor local goods and services. The rules implementing these legal provisions were enacted in June 2002 (Decree 612), but were not being enforced as of December 2003. The decree creates onerous requirements for government involvement in, and approval at, each stage of private companies' procurement processes.

Amendments applied to the Law on Subsurface Use in December of 2004 require investors to state in their tender proposals what affirmative actions they will take to satisfy local content requirements. Companies' operations can be suspended for up to six months if the company is found to fail consistently to meet the requirements. The law "On Production-Sharing Agreements (PSAs)" contains explicit requirements regarding local purchase of goods and services and the hiring of Kazakhstani nationals, and applies to all investment in offshore oil and gas exploration and production.

Kazakhstan recently added a controversial "pre-emption" amendment to its Law on Subsurface Use. The amendment guarantees the state a right of first refusal when a party seeks to sell any part of its stake in a mineral resource extraction project. The state claims this preeminent right even in cases where the controlling agreement assigns preemptive rights elsewhere (e.g. to other investors in a consortium.) The amendment specifically applies the preeminent right retroactively, as well. This new amendment raises serious questions about the Kazakhstani government's respect for contract sanctity. In October 2005, the Government's assertion of pre-emptive rights under national law became even broader. The Government now claims that the pre-emptive right exists when an investor attempts to gain access to drilling rights by purchasing a company that had them previously. Theoretically, this latest expression of the pre-emptive right (which has not yet been tested) could be read as a statement that the Government of Kazakhstan has a preferential right to purchase or prevent the sale of stock in a company that is involved in the oil, gas or mining business in Kazakhstan.

Gas flaring was prohibited altogether by 2004 Law on

Subsurface Use, except in emergency cases. Amendments adopted in October 2005 mitigate this requirement, providing for a transition period up to July 1, 2006 for subsurface users to draft and present a program for gas utilization to the government authorities.

In July 2005, Kazakhstan enacted a new law "On Production

Sharing Agreements (PSAs)", which establishes the state oil company's right to a minimum 50% share in offshore projects. The law also defines a new means by which the national oil company may obtain field rights outside of a tender process. Taken together, these clauses establish KazMunayGas as a necessary partner for international oil companies investing offshore, at least in the initial stages of an agreement.

In October 2005, customs duties on the export of oil products were introduced by a decree of the Prime Minister (Decree 1036). The government's decision is a timely political measure to reduce the export of oil products and stabilize domestic prices after a "gasoline crisis" in autumn 2005.

Kazakhstani law allows both citizens of Kazakhstan and foreigners to own land under commercial and non-commercial buildings, including dwellings and associated land. Such land may be leased up to 49 years. In June 2003, a new Land Code came into effect, which for the first time allows the private ownership by Kazakhstanis of agricultural land, in addition to industrial, commercial and residential land. However, foreign individuals and companies may still only lease agricultural land for up to 10 years, although the wording of the law is unclear with regard to purchase of such land by local legal entities, either wholly-owned or joint ventures.

Kazakhstani authorities often require, as part of a foreign firm's contract with the Government, that the firm contribute to social programs for local communities.

Foreign insurance companies are limited to operating in Kazakhstan through joint ventures with Kazakhstani companies. Overall capital of all foreign insurance companies should not exceed 25 percent of the non-life insurance market and 50 percent of the life insurance market. The total registered capital of banks with foreign participation is less than 25 percent of the total registered capital of all banks in Kazakhstan. Foreign ownership of individual mass media companies is limited to 20 percent. Legislation is under consideration that would lift the restrictions on foreign participation in the registered capital of Kazakhstani banks, but it would leave the other above-mentioned restrictions in place.

Difficulty in obtaining work permits for foreign investors' employees in Kazakhstan continues to be a problem. In 2001, a quota system was established that limited the number of work permits for that year to 10,500, with exceptions for investor's lead representatives. The quota is set each year, based on a percentage of the total national workforce. Many companies report that permits for key managers and technicians are routinely rejected or granted for unreasonably short periods, or are conditioned upon demands for additional local hires. Companies also note that the regulations are confusing and interpreted differently by various local officials and the Ministry of Labor and Social Protection.

However, the Government has been steadily increasing the number of work permits available. In 2003, the number of permits was limited to 0.14 percent of the economically active population (reckoned to be 8 million people), an amount that increased to 0.21 percent in 2004 and 0.28 (and again to 0.32) percent in 2005. In the first half of 2005, 15,086 people were holding valid work permits.

Kazakhstan adopted the law "On International Commercial Arbitration" in late 2004. The law regulates the activity of international arbitration institutions in Kazakhstan at all stages: from the adoption of an arbitration clause in a contract through the execution of an arbitration decision. This law defines the organizational and legal aspects of arbitration proceedings in Kazakhstan, and the conditions for recognition and execution of arbitration decisions made in foreign states. In practice, the Government of Kazakhstan has not consistently observed international practices relating to arbitration awards.

OTHER BARRIERS

There are other structural barriers to investment in Kazakhstan, including a weak system of business law, a lack of effective judicial process for breach-of-contract resolution, and an unwieldy government bureaucracy. Many companies report significant logistical difficulties serving the Kazakhstani market. In addition, there is a burdensome

tax monitoring system for all companies operating in Kazakhstan. Many companies report needing to maintain atypically large back-office operations in Kazakhstan to deal with the tax system and frequent inspections.

In 2001, Kazakhstan adopted transfer-pricing legislation that gave tax and customs officials the authority to monitor export and import transactions in order to stop distortion of earnings through manipulation of export prices. Foreign investors are concerned because the government rejected use of OECD standards to determine proper market prices, creating instead a methodology that fails to account for all cost and quality differences. The government also holds that transfer pricing can take place even in transactions between unaffiliated parties.

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